UNITED STATES TAX COURT
WASHINGTON, DC 20217

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HENRY J. LAZNIARZ & GINA M. LAZNIARZ,	)	
Petitioners,	)	
v.	)	Docket No. 31002-09.
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent	)	

O R D E R

Pursuant to the opinion of the Court as set forth in the pages of the transcript of the proceedings before Judge David Gustafson at St. Paul, Minnesota, on October 30, 2013, containing his oral findings of fact and opinion, it is

ORDERED that the Clerk of the Court shall transmit herewith to petitioners and to respondent a copy of the pages of the transcript of the trial in the above case before Judge Gustafson at St. Paul, Minnesota, containing his oral findings of fact and opinion rendered at the trial session at which the case was heard.

In accordance with the oral findings of fact and opinion, decision will be entered under Rule 155.

(Signed) David Gustafson
Judge

Dated: Washington, D.C.
November 13, 2013

SERVED Nov 14 2013

Bench Opinion by Judge David Gustafson
October 30, 2013
Henry J. Lazniarz & Gina M. Lazniarz
Docket No. 31002-09

THE COURT: The Court has decided to render the following as its oral Findings of Fact and Opinion in this case. This Bench Opinion is made pursuant to the authority granted by section 7459(b) of the Internal Revenue Code and Rule 152 of the Tax Court Rules; and it shall not be relied on as precedent in any other case.

By notice of deficiency dated October 2, 2009 (Ex. 1-R), the Internal Revenue Service (IRS) determined a deficiency in the Federal income tax of petitioners Henry J. and Gina M. Lazniarz, for the year 2006, along with an accuracy-related penalty pursuant to section 6662(a). After concessions (the IRS conceded a gross receipts issue, and petitioners withdrew their contention as to a net operating loss carryforward deduction), the issues for decision are whether petitioners substantiated an entitlement to deductions that the IRS disallowed, and whether petitioners are liable for the accuracy-related penalty.

Procedural history

This case was tried in St. Paul, Minnesota--first in February 2012. Before that trial the parties submitted a stipulation of facts to which were attached four documents (two of which--Exhibits 3-J and 4-J-were composite documents consisting of documents petitioners relied on to support their contentions; Stip. 7, 10). At the first trial, testimony was given by Mr. Lazniarz and by an attorney he had retained for development-related legal work; and petitioners also offered into evidence four documents, one of which (Exhibit 6-P, a calendar or day-timer) was received into evidence at that trial.

New counsel for petitioner entered the case after the trial, filed petitioners' post-trial brief, and moved for a new trial, arguing that "little evidence was adduced at trial". By order of August 7, 2013, the Court granted that motion on the grounds that petitioners' prior counsel had not represented them adequately.

The case was then tried for the second time on October 29, 2013. At the commencement of the trial, the Court stated that the trial record would be made anew at the second trial, and that the parties should be careful to offer into evidence at

the second trial all the evidence on which they intended to rely, whether or not it had been offered or received into evidence at the first trial. The Court stated that the previously filed stipulation (with its four exhibits) was considered to be in evidence pursuant to Rule 91(c) and asked petitioners whether they wished to offer into evidence any of the other exhibits they had offered at the first trial. Petitioners declined, and the only substantive evidence that they offered for the first time at the second trial was a carbon copy of a check (Ex. 14-P, which was received into evidence without objection) and Exhibit 15-P, discussed below (which was excluded on grounds of hearsay and lack of foundation). Petitioners also offered into evidence summary exhibits (Exs. 9-P to 13-P), pursuant to Federal Rule of Evidence 1006, which purport to summarize the substantiation otherwise in the record, and which were received into evidence over respondent's objection. Mr. Lazniarz testified again at the second trial but the lawyer did not. Petitioners also called a second witness--an accountant whom they had hired to prepare the summary exhibits.

On the evidence now before us, we find the following facts:

FINDINGS OF FACT

Real estate development activity

Mr. Lazniarz is a real estate developer, and the deductions at issue here relate to his real estate development activity. Benefitting from his engineering background, Mr. Lazniarz would conceive and design a project, investigate project sites, design buildings, and so on. It seems inevitable that in this process he would have incurred various expenses; but we are unable to quantify any such expenses beyond those that the IRS allowed after audit.

Tax return

To assist them in preparing their income tax return for 2006, petitioners hired a large accounting firm that they considered competent. They later came to believe that the firm had made errors by failing to claim all the deductions to which they were entitled, but we assume that at the time they hired the firm, it was a reasonable decision. The evidence does not show what information petitioners gave to their return preparer.

Petitioners filed a Form 1040 Federal income tax return for 2006 (Ex. 2-J). To that return they attached a Schedule C ("Profit or Loss from

Business"; Stip. 5) which related to Mr. Lazniarz's development activity. The Schedule C claimed deductions for, among other things, mortgage interest of $32,064 and legal and professional fees of $37,545. (Stip. 6) To the return they also attached a Schedule E ("Supplemental Income and Loss"; Stip. 8). Among the deductions claimed by petitioners on the Schedule E were insurance of $2,414, legal and professional services of $6,824, and real estate taxes of $11,163. (Stip. 9)

Notice of deficiency and petition

After examining petitioners' return, the IRS disallowed all of the mortgage interest and legal and professional fees claimed on the Schedule C; and of the deductions claimed on Schedule E, the IRS disallowed $1,663 of the insurance expense, the full amount of the claimed legal and professional expense, and $7,801 of the tax expense. The IRS issued its notice of deficiency on October 2, 2009 (Ex. 1-R); and petitioners timely filed their petition in this Court on December 29, 2009. At the time they filed their petition, they resided in Minnesota. (Stip. 1.)

OPINION

I. Substantiation

The IRS's determination is presumed correct, and taxpayers generally bear the burden to prove their entitlement to any deductions they claim. Rule 142(a). Deductions are a matter of legislative grace, and taxpayers must satisfy the specific requirements for any deduction claimed. See INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992). Furthermore, taxpayers are required to maintain records sufficient to substantiate their claimed deductions. See sec. 6001; 26 C.F.R. sec. 1.6001-1(a); see also id. sec. -1(e)("The books or records***shall be retained so long as the contents thereof may become material in the administration of any internal revenue law").

Mr. Lazniarz evidently did not maintain--or in any case did not offer into evidence--books of account for his development business. Rather, he offered only receipts and various other papers that he contends substantiate the expenditures. However, for each of the disputed deductions he failed to prove either the fact of the expenditure, the nature of the expenditure, or both.

The accountant whom he hired to prepare summaries of his expenses testified candidly that the summaries were not just a mathematical exercise but

rather reflected his "analysis" of whether an expenditure was deductible. It is evident that the accountant assumed that all the documents were authentic, that they substantiated the amounts they showed, and that they related to the development activity--assumptions about facts for which he certainly lacked personal knowledge. Thus, neither the accountant nor the summaries prove that Mr. Lazniarz incurred expenses in connection with his development activity that are properly deductible.

Mr. Lazniarz himself offered only the most general testimony about his alleged business expenses. For only one of the expenses--mortgage interest on Schedule C--did he comment on his collections of supposed substantiating documents, but he did not persuade us that they prove his point. For Schedule C mortgage interest expense, for example, he presented a tally of alleged interest payments to five lenders totaling $40,267 (Ex. 3-J at 001); but he did not explain how that total related to the different amount claimed on his return, and he presented no loan documents from any lenders. The largest of the five interest items on the tally is $21,630 allegedly paid to TCF Bank. He presented bank statements that do show monthly payments of

$2,545 to "TCF CONSUMER LEN" (Ex. 3-J at 005 et seq.), and he presented an amortization table of unclear provenance (with entries dated beginning 03/15/2011, not 2006) that purports to show the interest components of each payment (Ex. 3-J at 002). However, even if we overlook the difficulties in these documents and fully credit them for what they purport to show, we have no documentary evidence to show the purpose of the loan, whether business of personal. Mr. Lazniarz's narrative comments about the loans do not convince us of their business purpose.

For the other four of the five expenses in dispute, Mr. Lazniarz gave no detailed testimony whatsoever, but simply testified that he believed that the expenses reported on his return were incurred as alleged in connection with his development activity. Two of the disputed items were the legal and professional expenses on Schedule C and on Schedule E, for which petitioners offered Exhibit 15-P, an unsigned listing of hours allegedly spent by and billed by the lawyer in 2006 for legal work done in connection with Mr. Lazniarz's development activity. However, the document was prepared by the lawyer between the first and second trials (i.e., not

in the ordinary course but in anticipation of litigation); and, as is noted above, petitioners did not call the lawyer to testify. The document is inadmissible hearsay.

Thus, for most of the disputed deductions, no detailed testimony was given to corroborate the substantiating documents or to connect them to the business activity. When both parties had rested at the conclusion of trial, the Court pointed out to petitioner that he had not testified on most of the deductions, and petitioners' counsel answered that petitioners had given the evidence that could be presented in the time available. Since it was late in the day, the Court asked whether petitioners wished to resume trial the next day and put on additional evidence, but they declined. Thus, although the petitioners were given a second trial, and although they were warned at that second trial that their proof might be lacking, they failed to put on evidence sufficient to carry their burden of proof.

II. Penalty

Section 6662 imposes an "accuracy-related penalty" of 20 percent of the portion of the underpayment of tax that is attributable to any

substantial understatement of income tax. The precise amount of the 2006 understatement that will result from the adjustments that we have sustained is yet to be determined pursuant to Rule 155, but it seems clear that it will be "substantial" under section 6662(d)--i.e., that it will exceed both $5,000 and 10 percent of the tax that should have been reported. We therefore need not reach the issue of negligence.

Petitioners cannot successfully invoke any of the defenses that a taxpayer might assert against an accuracy-related penalty: They had no "substantial authority"; for their position (see sec. 6662(d)(2)(B)(i)); they did not disclose on their return (see sec. 6662(d)(2)(B)(ii)(I)) that they could not substantiate their claimed deductions; and they did not show reasonable cause and good faith for their erroneous reporting (see sec. 6664(c)(1)). They attempt to invoke this third potential defense by showing that they hired a competent accounting firm to prepare their return; and the defense might be available if the evidence showed, for example, that they had relied on professional advice to take the erroneous deductions. To successfully invoke this defense, they would have to show that they gave

correct information to their return preparer and that the errors on the return were the result of the preparer's actions--but evidence of such facts is lacking.

So that the liabilities can be recalculated to reflect the parties' concessions and the determinations in this opinion, decision will be entered pursuant to Rule 155.

This concluded the Court's Oral Findings of Fact and Opinion in this case.

(Whereupon, at 10:43 a.m., the above-entitled matter was concluded.)